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Before the Government Reform Subcommittee on Regulatory Affairs
Committee on Government Reform
House of Representatives
Congress of the United States

At the Hearing Entitled:
A Balancing Act: Cost, Compliance, and Competitiveness after Sarbanes-Oxley

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I very much appreciate the opportunity to provide this written statement to the Government Reform Subcommittee on Regulatory Affairs in connection with its investigation of the health, liquidity and competitiveness of U.S. equity markets during the implementation of the Sarbanes-Oxley Act ("Sarbanes-Oxley").

Pink Sheets is the leading provider of pricing and financial information for the over-the-counter securities markets and, among other things, operates an Internet-based, electronic quotation and trade negotiation service for OTC equities for market makers and other broker-dealers registered under the Exchange Act. While Pink Sheets is well known as the primary trading venue for the stocks of smaller public companies, the bulk of Pink Sheets trading by dollar volume takes place in distressed or reorganizing issuers and the securities of large international issuers.

This written statement describes four of our observations about the impact of Sarbanes-Oxley. First, based on what we are hearing from issuers, we think Sarbanes-Oxley has negatively altered the relationship between issuers and auditing firms. Second, the statistics provide no support for the view that issuers are exiting the registration system in great numbers, as is sometimes claimed. Third, the evidence shows that U.S. markets and regulation continue to be competitive, although much can be learned from other market structures. Finally, we will describe our private initiatives to encourage cost-effective disclosure that protects investors.

The Effect of Sarbanes-Oxley on the Issuer/Auditor Relationship

I agree with everything about Sarbanes-Oxley, except for its costs. Sarbanes-Oxley has rightfully forced management to be responsible for their company's disclosure and accountants to stand behind their audits. Good internal controls are essential to the integrity of audited financial statements.

On the other hand, issuers report to us that the intrusion of auditors into the internal control process has left management without the ability to curtail unnecessary procedures. If the auditor insists that every paper clip must be counted to have effective controls, management is powerless to resist. By removing the vendor-client tension from the audit process, accounting costs are no longer within the audit client's control. This has the unfortunate result of providing an incentive on the part of the auditor to conduct unnecessary procedures with resulting runaway costs. I sincerely hope that the SEC's recent initiative to repair the Section 404 audit process by providing additional guidance will re-balance the client-auditor relationship and reign in the cost burden for all issuers, large and small.

Sarbanes-Oxley Has Not Caused a Mass Exodus from the Registration System

Before getting into the numbers, it is worthwhile to correct some common misconceptions.

The term "going dark" is commonly used to refer to companies that elect to deregister their securities under the Securities Exchange Act of 1934 (the "Exchange Act") because they have less than 300 holders of record. Where there continues to be public trading interest, the deregistered security generally is traded through facilities operated by Pink Sheets. The term should not be applied to issuers that "go private" because they are purchased by private investors. This distinction is not always made clear in the debate over Sarbanes-Oxley.

The term "going dark" is also somewhat misleading. Issuers of publicly traded securities have continuing public disclosure obligations, whether or not they have issued a class of securities registered under Section 12 of the Exchange Act. Federal securities laws require non-reporting issuers to make adequate current information about their business and securities publicly available under two important circumstances: First, when corporate insiders – officers, directors or large shareholders – are buying and selling securities in the public marketplace.[1] Second, when the issuer is encouraging the public to trade its stock by paying promoters to advertise its prospects.[2]

According to a recent Wharton study, 484 issuers elected to deregister, or "go dark," between 1998 and 2004.[3] The number of firms "going dark" reached a high of

[1] Rule 144(c)(2) under the Securities Act of 1933 (the "Securities Act") requires that adequate current information be made publicly available by non-reporting issuers when "control persons" are selling securities into the public markets. Rule 10b5-1 under the Exchange Act prohibits any person from purchasing or selling a security while in possession of material non-public information. Officer and directors of non-reporting companies generally will be in possession of material non-public information and cannot trade unless this information is made public.
[2] See SEC Petition for Rulemaking No. 4-519, submitted by R. Cromwell Coulson, "Request for Rulemaking under the Securities Act of 1933 to Expose and Prevent Unlawful and Deceptive Activities by Securities Promoters and Their Sponsors," (April 24, 2006).
[3] Leuz, Triantis and Wang, "Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations," March 13, 2006 (unpublished study), Table I. Attached as Exhibit A.

183 in 2003, falling off to 122 in 2004. We estimate that approximately 150 issuers elected to deregister during 2005 and another 35 during the first five months of this year, which means that approximately 700 issuers deregistered voluntarily during the period from 1998 to 2005.

Out of the 700 issuers that deregistered, approximately 500 issuers are currently trading in the Pink Sheets system. The remaining 200 issuers probably are no longer publicly traded. About 50 of the deregistered, but publicly traded, issuers, or 10%, provide disclosures to investors through the Pink Sheets News Service, an Internet site intended to encourage disclosure through private initiatives. The remaining 450, or 90% of these issuers, are truly dark – that is, providing little or no disclosures to investors. Of those truly dark we estimate that more than half would be classified as economically distressed so their exiting the disclosure system may be related to business distress rather than Sarbanes-Oxley. We also believe that managements of some truly dark issuers may be using the excuse of Sarbanes-Oxley to cut off the flow of information to shareholders to depress their stock price and buy out minority shareholders in a creeping takeover.

While the number of issuers going dark may seem high, from 2000 to 2005, approximately 5,500 issuers filed Form S1 or SB2 to register securities in the public markets for the first time. That was more than 10 times the number of issuers "going dark" during the period from 1998 to 2005. Already this year, 544 issuers have filed to be SEC registered. So, while there has been an increase in deregistration activity, it is simply not true that issuers are exiting the registration system en masse, as is sometimes claimed.

The Competitiveness of U.S. Capital Markets

This brings us to our third topic -- the impact of Sarbanes-Oxley on the competitiveness of our equity capital markets for small companies. There has been much discussion lately suggesting that, due to Sarbanes-Oxley, U.S. companies are flocking to Europe, and in the smaller public company space, to the AIM (Alternative Investment Market) tier operated by the London Stock Exchange. We don't really buy the argument that the success of AIM is related to Sarbanes-Oxley. We see substantially more Canadian and Australian companies listing on AIM than U.S. companies, and neither of those countries has adopted Sarbanes-Oxley or requires a Section 404 audit.[4]

That said, we think much can be learned from other markets. In studying the AIM and other successful markets for small companies, we were impressed by the fact that capital raising is perceived as an integral part of the listing process. The London Stock Exchange publicizes extensively the capital raised for its listed issuers to an extent that seems odd when compared to our brethren at the New York Stock Exchange or NASDAQ. Secondary market disclosure is part and parcel of the European capital raising process. AIM offers an intelligent listing process that is designed to provide

[5] Exhibit B contains a list of Canadian, Australian and U.S. Companies Listed on AIM.

smaller UK companies the opportunity to raise capital from the London investment community. It has successfully created a community of advisors and capital providers for smaller UK companies; it is not surprising that AIM is now finding a worldwide audience for the capital that an AIM listing can provide.

We think the reason capital raising is not perceived by U.S. markets as an integral part of the listing process is that federal securities laws tend to focus on disclosures made to purchasers of securities in public offerings, rather than the information needs of market participants. As far back as 1966, the late Milton Cohen persuasively argued that the emphasis should be the other way around.[5] That is, we would do a better job of protecting investors if we focused more on the information provided to market participants. After all, markets cannot operate efficiently without good information. And, capital raising cannot be effectively accomplished in the absence of efficient markets.

The production of information for the markets is largely a problem of incentives. Issuers that wish to raise capital view disclosure as a necessary means to that end and are only too happy to "open their kimono" if they believe that this will result in a nice pot of gold in the end from investors.

Issuers have much less reason to make disclosure to the markets if they have no current plans to raise capital. In the relatively difficult capital-raising market for smaller public companies that we have experienced in recent years, smaller issuers have tended to view disclosure as an expensive nuisance, an impression heightened by the increased costs imposed by Sarbanes-Oxley. This is particularly true if management's performance has been something less than brilliant; shareholders are known to get prickly when they receive a disappointing report about their investment.

We think the active participation of markets, such as AIM, in the capital raising process encourages better disclosure to investors. The best public service that can be provided by regulation, in our view, is to supply the additional incentives necessary to induce useful disclosure when market forces are insufficient to stimulate this socially beneficial behavior. When markets are involved in the capital raising process, issuers have much more incentive to continue providing disclosure to market participants. This is particularly true in the market for smaller public companies, where capital raising activities in the public markets have historically experienced abundance in some years followed by several lean years.

[5] In 1966, in an influential article, Milton Cohen proposed that the disclosure standards of the Exchange Act should be equivalent to those under the Securities Act: "[T]he combined disclosure requirement of these statutes would have been quite different if the 1933 and 1934 Acts (the latter as extended in 1964) had been enacted in opposite order, or had been enacted as a single, integrated statute--that is, if the starting point had been a statutory scheme of continuous disclosures covering issuers of actively traded securities and the question of special disclosures in connection with public offerings had been faced in this setting. Accordingly, it is my plea that there now be created a new coordinated disclosure system having as its basis the continuous disclosure system of the 1934 Act and treating "1933 Act" disclosure needs on this foundation." Cohen, "Truth in Securities Revisited," 79 *Harv. L. Rev.* 1340, 1341-1342, as quoted by Loss and Seligman, *Securities Regulations* § 2-D-1, *n. 2*.

We have learned much from AIM; I would respectfully suggest that the Subcommittee's work would be enhanced by a thorough study of AIM to see what can usefully be done here to improve our markets and the capital-raising process.

Pink Sheets Initiatives to Encourage Better Disclosure by Issuers

There can be no doubt that securities markets best perform their function of setting fair and accurate prices where buyers and sellers have full and complete access to all material information.[6] Nevertheless, as a practical matter, information cannot be made available without cost, and good information may be quite costly to produce. Sarbanes-Oxley has increased the cost of providing information for reporting companies, and this increased cost has resulted in more issuers going dark.[7] As a result, requiring all issuers of publicly traded securities to be registered and fully reporting is probably impractical.

The fact is that registration is not an end in itself, but a means to an end. The purpose of registration is disclosure. Registration and SEC filings provide a mechanism to make sure that investors are receiving the information they need to make sensible investment decisions.

Registration is not the only way that investors receive information. Bankrupt issuers cannot satisfy the registration requirements of the Exchange Act because their financial statements cannot be audited without qualification. But, issuers in reorganization produce reams of publicly available information about their finances and operations, most of which is available through the Internet. At Pink Sheets, we have been encouraging non-reporting issuers to provide information to investors through postings in the Pink Sheets News Service. We submit that it shouldn't matter to investors whether they obtain the information through a government website, such as the SEC's EDGAR site for reporting issuers, or the Internet sites made available by the bankruptcy courts, or through a privately-operated site, such as the Pink Sheets News Service. It is the quality of information, and the ability of investors to access that information freely, that counts, not the Internet site of its production.

This suggests that a more nuanced approach to market disclosure may result in better disclosure, and more efficient markets, than the current regime.

Two years ago, we launched the Pink Sheets News Service, an Internet repository where issuers can post information about their business and securities. This information is freely available to investors and regulators. We have encouraged issuers

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[6] As noted by a House Committee in 1934: "No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5, 11-12 (1934), as quoted by Loss, *supra*, § 6-A.

[7] See C. Coolidge, "Who Needs the Aggravation?" *Forbes*, October 14, 2002.

to follow the requirements for providing adequate current information found in Rule 144 under the Securities Act. Borrowing heavily from guidance published by the SEC, we published disclosure guidelines to encourage more complete disclosure.[8] This has all been done by private initiative – Pink Sheets is not a regulator. However, we do have the right to penalize issuers that fail to make good disclosure and have blocked quotes for the securities of issuers who failed to measure up to federal standards.[9]

Recently, we have taken things a step further by creating the OTCQX premium tiers.[10] Designed to clearly differentiate operating companies with audited financials that can meet certain minimum requirements, the OTCQX premium tiers provide issuers with a mechanism to publish quarterly and annual audited financial reports, management certifications, and interim event disclosure. The centralization of issuer-certified disclosure, together with listing standards for inclusion in the tiers, should substantially improve the OTC market, promote continued disclosure in the absence of SEC reporting, and highlight the best issuers in the OTC market to the investment community.

Pink Sheets lacks the resources to perform due diligence to confirm the reasonableness of issuer disclosure. Nonetheless, there is a need for some independent review because investors lack confidence in disclosures made by issuers without independent review. This is particularly true in the market for smaller public companies because the entrepreneurial spirit of this cohort often means that issuers are playing closer to the edge than their larger counterparts. The challenge is to encourage disclosure that will protect investors from questionable issuers and provide some form of independent review, without demanding so much costly disclosure that good companies will be driven out of business.

We were impressed by the solution conceived by AIM. Smaller companies are required to appoint a professional gatekeeper, which they call the nominating advisor or NOMAD, who works with the issuer and performs due diligence so that material information is disclosed to investors. Our OTCQX listing concept has been borrowed in large measure from the successful NOMAD used by AIM.

Companies listing in the Pink Sheets OTCQX premium tiers are required to appoint and pay for an attorney or broker-dealer to review its disclosures.[11] We call these appointed professionals “DADs,” which stands for “Designated Advisor for Disclosure.” We expect that DADs will review the non-financial portions of an issuer’s disclosure to determine whether there is a reasonable basis to believe the statements of the issuer regarding its business and competitive environment. As always, it is hoped that the attorney or broker-dealer, who will work for a fee and perhaps the hope of more business, will not be willing to risk loss of reputation and business viability to assist an

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[8] The Pink Sheets Guidelines for Providing Adequate Current Information are attached as Exhibit C.
[9] This is based on our freedom to determine who we will deal with and on what terms – the freedom of contract right enjoyed by every private citizen.
[10] A Brochure describing the OTCQX Premium Tiers is attached as Exhibit D.
[11] The OTCQX Rules are attached as Exhibit E.

issuer in the commission of a fraud or even questionable disclosure. The DAD will not be required to confirm the financials, which will still be audited.

We believe that a DAD or NOMAD may protect investors in small issuers more effectively than a Section 404 audit because much of the disclosure necessary to make good investment decisions is not contained in a company's GAAP financial statements. Investment decisions for smaller issuers are usually based on investor evaluation of the company's prospects. In contrast, financial disclosure prepared in accordance with US GAAP is historical, reflecting prior periods. It is a truism that "historical performance is no guarantee of future results," and this is clearly true of the smaller issuer working on a cure for cancer or some new technology that has no revenues. A company's plans and prospects must therefore be described in the non-financial and necessarily unaudited portions of an issuer's disclosure, and these disclosure elements bear heavily on the investment decision. The DAD can be useful in determining whether the smaller issuer's disclosure of its prospects has a reasonable basis in reality.

We think that the DAD will play such a valuable role for smaller issuers that we are agnostic if OTCQX issuers are SEC registered or just have audited U.S GAAP financials. In either case, an issuer listed in OTCQX will be required to appoint a DAD. But, we expect that almost all of the OTCQX issuers who are interested in raising capital will have a class of securities registered under the Exchange Act. Even with registered issuers, we think the DAD will serve the useful function of helping the issuer to "get it right," which should inspire greater investor confidence in OTCQX issuer disclosure.

Conclusion

We think that investors would be better protected if secondary markets were more involved in the capital raising process. Continuing market disclosure would then be viewed as paramount, as compared to disclosure provided to initial investors in public offerings. At the same time, considering the needs of market participants in connection with capital raising results in a more nuanced approach that considers, not only the benefits of disclosure, but also the costs of its production. We believe the result would be more efficient secondary markets and enhanced opportunities for capital-raising.

The great promise of the Exchange Act is to ensure the maintenance of fair and honest securities markets.[12] Adequate and regular public disclosure is the method most often employed under this legislation to achieve this great and lofty purpose. We hope this hearing is part of a dialog that will inspire a more sophisticated approach to market disclosure and investor protection in the securities of smaller public companies.

At Pink Sheets we see great opportunities to create a vibrant and successful secondary market for small companies. A study commissioned by the AIM stated that a vibrant market for Small to Medium Enterprises can add as much as 1% to the GDP of a

[12] See Exchange Act, Section 2.

country's economy.[13] We hope OTCQX becomes a vibrant market that contributes to this worthy goal.

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[13] Oxford Analytica, "Assessment of the Economic Benefits and Opportunities for a Pan-European Growth Market," (October2005). Attached as Exhibit E.